

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

74-2405

United States Court of Appeals

FOR THE SECOND CIRCUIT

GERALD L. HERZFELD,

Plaintiff-Appellee,

—ag. inst—

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
Defendant-Appellant.

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
Third-Party Plaintiff-Appellee,

—against—

ALLEN & COMPANY, INCORPORATED and ALLEN & COMPANY,
Third-Party Defendants-Appellants.

ALLEN & COMPANY and ALLEN & COMPANY, INCORPORATED,
Third-Party Counter-claimants-Appellants,

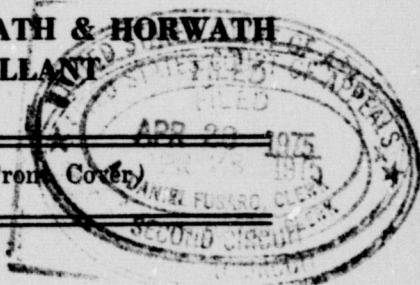
—against—

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
*Third-Party Counterclaim
Respondent-Appellee.*

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF OF
LAVENTHOL KREKSTEIN HORWATH & HORWATH
AS DEFENDANT-APPELLANT**

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**BRIEF OF
LAVENTHOL KREKSTEIN HORWATH & HORWATH
AS DEFENDANT-APPELLANT**

Preliminary Statement

Laventhol Krekstein Horwath & Horwath ("Laventhol") appeals from an Amended Judgment (1129a* *et seq.*) entered against it in the United States District Court for the Southern District of New York after trial before Hon. Lloyd F. MacMahon without a jury, in favor of plaintiff-appellee Gerald L. Herzfeld ("Herzfeld") in the amount of \$153,000 with costs and interest, upon a finding of liability under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)), Section 352-c of the General Business Law of the State of New York (McKinney's 1968) and the common law.

Issues Presented

1. Did the District Court err in holding that causation in fact and reliance had been established although the plaintiff purchased his securities in a private placement before receiving the allegedly misleading auditor's report and audited financials and thereafter retained the securities without ever reading the auditor's report or considering the material portions of the audited financial statements?

2. Did the District Court err in defining the scope and character of disclosure required of accountants, and, particularly, in holding that even though the auditor's report complied in good faith with generally accepted accounting principles, it was materially misleading by reason of its

* Unless otherwise indicated, all references designated "a" are to pages of the first four volumes of the Joint Appendix in this appeal and all references designated "e" are to pages of the last two volumes of the Joint Appendix in this appeal.

failure to include certain descriptive and evaluative materials about the affairs of the issuer listed by the Court in its Opinion?

3. Did the District Court err in holding that the requisite *scienter* had been established, *inter alia*, by inferring a knowing suppression of doubt about the financial statements from the qualified opinion in which the auditors expressed those very doubts in a manner consistent with generally accepted accounting principles?

4. Did the District Court err in holding that the facts supported a finding of liability for common law deceit against the auditors?

5. Did the District Court err in (a) reaching the question of whether Section 352-c of the New York General Business Law (McKinney's 1968) provided a private cause of action for plaintiff and (b) concluding that the auditors were liable thereunder?

Statement of Case

A. *The Nature of the Case and Proceedings Below.*

As noted above, the Amended Judgment (1129a *et seq.*) ran against Laventhol and in favor of Herzfeld in the amount of \$153,000 with costs and interest. The Amended Judgment gave recovery for contribution in the amount of \$76,500 with costs and interest in favor of Laventhol as third-party plaintiff against third-party defendant-appellant Allen & Company, Incorporated ("Allen"), dismissed third-party counterclaims by Allen and Allen & Company ("Allen & Co.") against Laventhol, and dismissed the

Third-Party Complaint as against one Irwin H. Kramer ("Kramer"). Notices of appeal were filed by Laventhol and by Allen and Allen & Co. (1132-1133a; 1134-1135a).*

This action was initially brought by Herzfeld against 12 defendants to recover \$510,000 in damages suffered after Herzfeld purchased securities of The Firestone Group, Ltd. ("Firestone Group") in a private placement managed by Allen (10a *et seq.*). Herzfeld's Complaint charged the 12 defendants with making false and misleading oral and written representations to him in violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)), Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)), Section 352-c of the General Business Law of the State of New York (McKinney's 1968) and the common law.

Shortly after the commencement of the action, and unbeknownst to defendant Laventhol, Allen successfully negotiated and concluded a settlement with Herzfeld whereby Herzfeld released his claims against the 11 defendants other than Laventhol for approximately \$357,000 (62-64a). The discontinuance of the action against defendants other than Laventhol was approved by the Court over Laventhol's objection that it had crossclaims for contribution and indemnification (not yet pleaded at that time) against Allen and other defendants (88-94a). Allen and the Court pointed out that Laventhol could preserve those claims for contribution and indemnification by serving a third-party complaint (71a).

* This Brief will address only those issues raised by the appeal from the Amended Judgment by Laventhol as defendant-appellant. Laventhol will, if need be, file a separate, non-repetitive brief as "third-party plaintiff-appellee" and "third-party counterclaim respondent-appellee" in response to any issues which may be raised by Allen and Allen & Co. as third-party defendants-appellants and third-party counter-claimants-appellants.

Thereafter, Herzfeld served an Amended Complaint alleging violations of the same laws as alleged in the Complaint but naming only Laventhol as a defendant and seeking damages of \$153,000. The Amended Complaint alleged that Herzfeld had purchased Firestone Group securities in reliance upon Laventhol's December 6, 1969 written report on Firestone Group's audited financial statements for the eleven-month period ended November 30, 1969 and charged that Laventhol's report and Firestone Group's audited financial statements were false and misleading (105a *et seq.*). Laventhol served an Answer denying liability (117a *et seq.*) and a Third-Party Complaint seeking contribution and indemnification from nine third-party defendants (131a *et seq.*). Thereafter, two of the third-party defendants, Allen and Allen & Co., asserted certain claims against Laventhol as third-party counterclaimants (144a *et seq.*).

The action was tried before Hon. Lloyd F. MacMahon from October 15, 1973 through October 29, 1973.* The Opinion of the Court was filed on May 29, 1974 (176a), and was subsequently modified (1129a *et seq.*).

B. Factual Background.

In 1969, Firestone Group was a company engaged principally in the business of purchasing real estate and thereafter syndicating or otherwise selling it (763a). Allen was

* By the conclusion of the trial, Herzfeld had been permitted to further amend his Amended Complaint so that the claims were asserted by him as an individual and as a general partner of General Investors Co., an investment vehicle utilized by him and by his two brothers (177a; 239a). Herzfeld and General Investors Co., unless the context requires other treatment, will herein be referred to collectively as "Herzfeld".

Firestone Group's investment banker and Lee Meyer, a vice-president of Allen, held one of three seats on Firestone Group's Board of Directors (546-547a; 698-699a; 763-764a).

In November 1969, Firestone Group embarked on a plan to sell units of its securities to a small number of purchasers in a private placement managed by Allen (546-547a; 709a). Each unit consisted of a \$250,000 Firestone Group note and 5,000 shares of Firestone Group common stock. Each unit was purchased by a private investor in accordance with a Note and Stock Purchase Agreement dated November 10, 1969 (7e), the last two pages of which contained projected, unaudited Firestone Group financial statements for the period ended November 30, 1969 (22-23e). These unaudited financial statements anticipated the results of transactions which were then in negotiation and which were to be concluded by November 30, 1969 (9e).

Herzfeld learned of the Firestone Group private placement in early November 1969 from his friend David Baird ("Baird"), and shortly thereafter from his friend Kramer, an Allen officer. Baird and Kramer both described the Firestone Group private placement in highly enthusiastic terms. Each offered Herzfeld a unit of the securities, and Herzfeld agreed to buy each of the units offered by Baird and Kramer (208a; 220-221a; 289-290a; 306-311a).

Thereafter, and on or about November 21, 1969, Herzfeld received from Firestone Group the November 10, 1969 Note and Stock Purchase Agreement (7e; 268e; 317a) together with a letter saying that audited financial statements, to be supplied at the closing, would confirm the unaudited statements in the Note and Stock Purchase Agreement (171e). The Note and Stock Purchase Agreement itself provided

as a condition of closing that such audited statements would confirm the unaudited statements as "correct and complete" (9e).

Herzfeld read and analyzed with care the Note and Stock Purchase Agreement including the projected, unaudited financial statements. He then signed the Note and Stock Purchase Agreement sometime on or before November 24, 1969 and returned it to the attorneys for Allen (273-274e; 279e). Thereafter, in early December 1969, Herzfeld made elaborate arrangements for checks totalling \$510,000 to be delivered to Allen in payment for the securities (260a; 342-345a). The purchase was closed and funds passed on December 16, 1969 (5-6e; 178a).

In November 1969, at the same time Firestone Group was pursuing the private placement through Allen, Firestone Group was also completing negotiations with Monterey Inns, Inc. ("Monterey") and Max Ruderian ("Ruderian"), a wealthy and successful real estate syndicator, for Firestone Group's purchase from Monterey and sale to one of Ruderian's companies of certain nursing home properties (772-788a). These transactions ("Monterey transactions") were collectively the largest Firestone Group transactions in 1969 (789a).

In mid-November 1969, Firestone Group asked Laventhol to audit and report on its financial statements for the eleven months to end November 30, 1969. The resultant audit report and the attached audited financial statements (124a *et seq.*) were delivered to Firestone Group in California on or about December 11, 1969 (943a; 958-959a).

The audited financial statements gave effect to the Monterey transactions as a purchase and a sale of property in

the amounts of \$13,362,500 and \$15,393,000, respectively. However, Laventhol decided that, consistent with generally accepted accounting principles, only a portion of the profit anticipated from the transactions could be taken into income for the eleven months ending November 30, 1969 (180a; 840-841a; 940a). It consequently insisted that \$1,795,000 of the difference between purchase price and sale price be "deferred" as income and be so displayed, with an explanatory footnote on the income statement. Moreover, in light of a number of circumstances (referred to hereafter), Laventhol insisted that the fairness of the presentation of the financial condition of Firestone Group required that its opinion be qualified to show that it was "subject to the collectibility of the balance receivable on the contract of sale (See Note 4)" (32e).

Laventhol took this view even though its audit unequivocally revealed that all of the principals regarded the transactions as firm (825-828a; 551-552a), even though Laventhol's investigation of Ruderian had borne out his excellent reputation as a man of great wealth and business experience (779a; 823a) and although Ruderian had personally assured Laventhol that he fully intended to go forward with the deal (827-829a). Laventhol felt that its report should be qualified because of several factors: Continental Recreation, Inc. ("Continental"), a company which Ruderian controlled, had paid only \$25,000 when Ruderian and Firestone Group signed the contract on November 26, 1969 (841-845a); the remaining amounts to be paid before the closing, \$25,000 on January 2, 1970 and \$4,965,250 on January 30, 1970, were very large; the contract of sale provided for liquidated damages of \$185,000 in the event Continental failed to pay the large amounts due (145e); and Continental's net worth was \$100,000 (618a).

Thus, despite the assurances it received from all concerned, Laventhol took the position that Firestone Group could take into income for the eleven months ending November 30, 1969 only \$235,000 of the profit anticipated from the Monterey transactions and that the remaining \$1,795,500 of projected profit could not be so included (840-841a). The \$235,000 amount was decided upon as a judgment figure based on consideration of all these factors known to Laventhol and was quantitatively equivalent to the aggregate amount of the down payments and the provision for liquidated damages (854-858a).

Laventhol required that the \$1,795,500 of projected profit be described as "deferred" in the balance sheet and in the income statement and that it be *deducted* from profits from sales listed on the income statement. Laventhol also required that all balance sheet and income statement items referring to the "deferred" item be referenced to footnote 4. The report, balance sheet and income statement together contain six separate references to that footnote which described the essential terms of the two contracts. It specified the amounts and dates of payments made and *to be made* under the contract between Monterey and Firestone Group and under the contract between Firestone Group and Continental. It also stated that the Firestone Group-Continental contract contained a \$185,000 liquidated damages provision "if the buyer fails to perform" (37e).

Firestone Group and Allen concluded that the audited figures did not "confirm" the unaudited financials in the Note and Stock Purchase Agreement as required by the latter's terms (977a). They strenuously objected to Laventhol's refusal to allow \$1,795,500 of the profit anticipated from the Monterey transactions to be taken into income.

They also objected to the qualification in Laventhol's report (803-805a; 940-941a; 947a). They remonstrated with Laventhol that the Monterey transactions were firm and the anticipated profit should neither be excluded from current income to any extent nor be the subject of a qualification in Laventhol's opinion (801-803a; 893-895a). Laventhol would not acquiesce (805a; 973a). The Firestone Group then threatened to sue Laventhol (942a) for jeopardizing the private placement, and, when Laventhol still refused to alter its report, Firestone Group and Allen: (a) closed the private placement on December 16; (b) drafted a summary of "differences" between the audited and unaudited statements on the same date (974a); and (c) sent that summary with the Laventhol report (261-262a) to the private investors in a December 16, 1969 letter (225-226a) which "explained" the differences, represented the differences not to be material or adverse (223a; 971-972a), and stated that any investor could rescind his purchase before January 9, 1970 (28-30e; 262a).

Although Herzfeld was a successful, sophisticated businessman who had previously engaged in a "great number" of securities transactions personally and through General Investors Co. (247-256e) and had received and understood the significance of qualified reports by certified public accountants (323e), *Herzfeld did not read the Laventhol report* when he received it for the first time a day or more after the closing (325-326a). He did read the description of "differences" in the December 16, 1969 letter (326-328a).

Except for looking at the income statement and noting the line listing the "deferred gross profit" and the line listing Firestone Group's net income (329-333a), Herzfeld did

not read the Firestone Group audited financial statements. Herzfeld testified that even though the "deferred gross profit" line explicitly referred the reader to Note 4, he did not read Note 4 at all (335-336a). Herzfeld further admitted that if he had read the Laventhol report and noticed its qualification, he would have concluded that the audited financial statements were "meaningless" (337e).

Many months thereafter, the Monterey transactions fell through, and more than a year later, Firestone Group filed in Chapter XI, whereupon Herzfeld brought his action.

Summary of Argument

I.

Herzfeld did not rely on the Laventhol report in either his initial purchase or later retention of the Firestone Group units. He did not have the report before his purchase and did not read the report after his purchase when he retained the units. Had he examined the Laventhol report, he would have discovered that it contradicted in major respects the Firestone Group financial projections on the basis of which he originally purchased, and he confessedly would have found the audited statements "meaningless" if he had seen that they were subject to a qualified opinion. In retaining the units, Herzfeld rather relied on enthusiastic salesmanship and unaudited projections and on the blatantly misleading "explanatory" material furnished by Firestone Group and Allen.

The conclusion below that Herzfeld's purchase or retention of the units was caused by reliance on the Laventhol report is tantamount to the creation of an irrebuttable

presumption of causation in fact from alleged affirmative misrepresentations, and constitutes palpable error under well-established principles in this Circuit.

II.

Laventhol's good faith compliance with generally accepted accounting principles under the circumstances here fully satisfied the duty of disclosure properly imposed on accountants. The Court, in demanding more expansive disclosure by Laventhol, (a) established an erroneous standard which failed to recognize the differing duties and competence of issuers and auditors and (b) listed a group of unbalanced, inaccurate and plainly immaterial "facts" required in its view to be disclosed. Both the standards of disclosure formulated by the District Court and its application of the standards to the instant facts were seriously in error.

III.

The Court erred in holding that Laventhol's failure to anticipate the novel disclosure requirement announced below showed *scienter* as that term has been repeatedly defined here. The Court below was particularly in error in inferring a wilful or reckless suppression of doubt about the Monterey transactions from the accountants' qualified opinion which expressed those doubts in the manner required by applicable professional standards.

IV.

The standards of liability at common law being more demanding than those under Rule 10b-5, the Court erred, *a fortiori*, in holding that Laventhol was guilty of common law fraud under New York law.

V.

The Court gratuitously and erroneously decided that a private cause of action existed under New York General Business Law Section 352-c, a criminal statute, and gave plaintiff recovery thereunder. The Court should have abstained from deciding a novel point of New York statutory law. In any event, upon reaching the point, the Court decided it wrongly.

POINT I

The Court below erred in determining that the Laventhol report caused Herzfeld to engage in the Firestone Group investment.

Herzfeld bought his Firestone Group units in a private placement consummated before he received the Laventhol report (25-27e; 316-317e; 326a); he thereafter retained his units without ever having read the Laventhol report (325-326a; 329a); and he admits that if he had not ignored the report he would have discovered that it was qualified as to a significant item and that fact alone would have destroyed for him all the value of the audited statements (337e).

Yet the Court below found actual reliance by Herzfeld. Laventhol contends that in so doing, the District Court committed clear and grievous error and, in the process, announced a standard of causation in fact utterly at odds with the well-established doctrine of this Circuit.

A. *The Applicable Standard of Causation in Fact and Reliance.*

To make out a claim for damages based upon alleged transgressions of Rule 10b-5, a plaintiff must establish a causal nexus between the transaction in which he sustained

a loss and the asserted violation by the defendant. While this causal element has gone by various names in various cases, including "transactional causation", "reliance", "materiality" and "buyer-seller doctrine", it has never been doubted in this Circuit that "Causation remains a necessary element in a private action for damages under Rule 10b-5." *Titan Group, Inc. v. Faggen*, Dkt. No. 74-1694—F.2d— (2d Cir. April 1, 1975) (Slip Op. 2663 at 2670).*

This Court in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *petition for cert. filed*, 43 U.S.L.W. 3502 (U.S. March 13, 1975) (No. 74-1155), recently synthesized the uniform holdings of this Circuit and reiterated its long established rule on this point:

"This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question. The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. *Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that*

* *E.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811, *rehearing denied*, 382 U.S. 933 (1965); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Shapiro v. Mcrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974). VI *Loss, Securities Regulation*, 3876-77 (1969); Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev., 1398, 1423 (1974); Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562 (1972).

he relied on the misrepresentations in question when he entered into the transaction which caused him harm. 2 Bromberg §8.6, at 209-11." (Last emphasis supplied.)

The Court below gave lip service to the pertinence of this doctrine, but in applying it to the facts of record here, totally eviscerated it. To recover under this standard, Herzfeld had to show that, either in deciding to purchase the Firestone Group units or in deciding not to rescind that purchase, "he relied on the misrepresentations in question". The evidence, as we shall develop, is wholly to the contrary.*

The Court below erred, then, first in discerning in conduct which was demonstrably devoid of reliance that showing of reliance consistently required in cases of alleged affirmative representation. The further doctrinal misstep implicit in the Court's Opinion becomes even more apparent from an insight gleaned from the cases dealing with causation in fact in the context of nondisclosure.

In nondisclosure cases (which this case is not), it may be permissible to indulge a presumption of causation in fact if all the circumstances warrant an inference that plaintiff would likely have been influenced to act differently if the undisclosed fact had been revealed. *See, e.g., Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Chasins v. Smith, Barney and Co.*, *supra* at 1172; *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra* at 239. Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 *Harv. L. Rev.* 584, 587-89 (1975). This

* Insofar as the requirement of proof of reliance or causation is substantially the same or more stringent under the plaintiff's other legal theories of recovery, references in this point to Section 10(b) of the Securities Exchange Act of 1934 are intended to be equally applicable to plaintiff's other legal theories of recovery. *See* Points IV, V, *infra*.

Court has recently spoken again on this point "in instances of total nondisclosure", distinguishing from them the more rigorous standard of proof applicable in "instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements. . . ." *Titan Group, Inc. v. Faggen*, *supra* at 2670.

Even in such omission cases, however, the courts have refused to adopt a rule of *per se* causation in fact: where the presumption has been indulged, it has been regarded as rebuttable, susceptible to being overcome by proof at trial.* Invitations to this Court to dispense with that factual linkage have consistently been refused, fundamentally because "The parallel elements of materiality and reliance both serve to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists a causation in fact between the act and injury." *Titan Group, Inc. v. Faggen*, *supra* at 2669.** See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra* at 239.

The Court below, however, held in effect that there need not be evidence of a substantial link between the misstatements of which Herzfeld complains and his transaction and loss. Rather, the Court *conclusively* presumed a causative connection between the alleged misstatement and Herzfeld's investment decision. The Court neither insisted that plaintiff sustain the burden of proving actual reliance nor permitted the presumption of causation (inappropriately indulged in a misrepresentation case in the first place) to be rebutted by affirmative proof that there was no causal con-

* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, *supra* at 597-600; Stoll, *Reliance as an Element in 10b-5 Actions*, 53 *Oregon L. Rev.* 169 (1974).

** One commentator has pointed out that without reliance to establish the element of causation, the defendant becomes a guarantor. Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 *Colum. L. Rev.* 562, 565 (1972).

nection. The result is a novel rule, abruptly departing from the principles previously established and recently reapplied by this Court. Should the decision below be allowed to stand, its practical effect would be to eliminate causation in fact as a necessary element of proof in cases arising under Section 10(b).

B. The Proof on the Issue of Reliance and Causation in Fact.

1. Herzfeld did not rely on the Laventhol Report.

The Court below did not analyze with any clarity just what "transaction" the Laventhol report was supposed to have "caused" Herzfeld to engage in. Presumably the relevant transactions were Herzfeld's purchase of the Firestone Group units and his silent retention of those units after an opportunity to rescind the purchase had been afforded him by Firestone Group on December 16.

Both the record at trial and the Court's own findings of fact are utterly inconsistent with the possibility that Herzfeld's conduct in either instance was caused in fact by the Laventhol report.

As to the actual purchase of the units, it was found by the Court, upon the uncontradicted evidence, that Herzfeld signed the Note and Stock Purchase Agreement in late November before the Laventhol report was even issued, and that the purchase was admittedly closed, and full payment made by Herzfeld on December 16, at least one day before he received the Laventhol report (260-262a).

The evidence is also clear that the Laventhol report played no significant part in Herzfeld's decision to retain the units for the elementary reason that he did not read Laventhol's report, nor did he read any of the ma-

terial parts of the certified financial statements. Indeed, the Court recognized that he looked at only one page of the financial statements and, as to that, he noted only a few lines and chose to ignore the balance as well as footnote references (210a).

Herzfeld physically looked at only one page of the financials, the income statement, and that page incompletely and without care. He did not read at all the footnote which explained the Monterey transactions. He never read the opinion of the auditors and, consequently, never knew that the opinion was qualified and subject to the collectibility of amounts yet to be received pursuant to the Monterey contract. Separately and cumulatively, these facts demolish any possible contention that the Laventhol report caused Herzfeld to abstain from rescinding.

The Court seized upon the fact that Herzfeld claimed to have read the income statement in the Laventhol report and to have been "impressed" by the deferred gross profit figure, as the basis for finding that "plaintiffs have shown sufficient reliance on the Laventhol report" (211a).

First of all, it is apparent that, if Herzfeld was impressed by the deferred gross profit figure, it was because he assiduously avoided even glancing at any of the portions of the report that would have told him what the deferred gross profit line meant. The Court observed that Herzfeld regarded the deferred gross profit as meaning "that this is a profit that the company had made and was going to pick up in a subsequent accounting period" (210a). But, as the report plainly stated, that is not at all what the deferred gross profit figure meant. The line contained explicit reference to footnote 4, which explained the Monterey transactions in full. All of the deferred gross profit figure was subject to future collection, the realiza-

tion of which was so uncertain in the minds of the accountants that they qualified their opinion in this regard. But this opinion Herzfeld also neglected to read. The figure itself is *subtracted* on the face of the income statement from the gross profit from sales in order to produce the net profit for the period.

Had Herzfeld considered the income statement, or read any of the pertinent explanatory materials which are an integral part of the financial statements (391-392a), he could not possibly have been as factually mistaken and as easily "impressed" as he claims to have been.* Assuming that he read the income statement at all, this eclectic approach to an integral statement cannot support a finding of the requisite reliance.

Finally, although Herzfeld had carefully read the Firestone Group unaudited financials when he first bought the units, he made no comparison between the audited income statement and the unaudited figures in the Note and Stock Purchase Agreement in order to establish whether the former confirmed the latter (332-334a).

It is plain, and the Court so found, that Herzfeld did not read footnote 4 despite six separate references to it in the accountant's opinion and the company's financial statements, including one appended to the line regarding the deferred gross profit (331a; 336e). Apart from the fact that his refusal to read the critical explanatory footnote destroys any argument that he relied on it to his detriment, and apart from the fact that his refusal to read

* Indeed, he testified that he would not have been impressed with the financial statements had he read the qualified report (337e). The opinion thus produces the strange result that plaintiff can be found to rely if he read only part of the report, even though he would not have relied had he read it all.

it dissipates any reliance he might claim on the portions of the income statement to which it was affixed, his neglect of footnote 4 discloses trenchantly his total lack of concern for the content of the Laventhol report.

Herzfeld received the Laventhol report together with a covering letter from Firestone Group purporting to explain the discrepancies between the audited and unaudited financial statements. At trial he admitted that he accepted the explanation in the Firestone Group letter and did not even read the explanation in Note 4 (335-336a). The record is uncontroverted that Laventhol had nothing whatsoever to do with the Firestone Group letter (806-807a; 974a).

Finally, Herzfeld did not read the opinion of the auditors itself (336e) although that opinion is the statement which accountants make to investors. He therefore did not know that the opinion was materially qualified. The significance of the qualification to him as an experienced investor was made clear by this testimony, given at his deposition and introduced at trial (337e):

"At the time I looked at this statement I didn't read the first page. But if I had read it, it would be a meaningless thing to me if they say subject to the collectibility. To me that would be the same as saying subject to the accuracy of the entire statement."

In brief, then, Herzfeld ignored the material expressions of opinion and explanation in the Laventhol report at the time he decided not to rescind; he may have glanced at the income statement page but neither understood nor analyzed it, and insofar as he paid attention to the deferred gross profit figure he had recourse to Firestone Group's explanatory letter, rather than to Laventhol's footnote 4, to explain its significance to him.

Under these circumstances, it is plain that the Laventhol report played no significant part in Herzfeld's decision to retain the Firestone Group units. This is evident from Herzfeld's treatment of the Laventhol report; it is reinforced by all of the testimony concerning the impact the Laventhol report had on those who did read it as well as by Herzfeld's testimony as to what he did rely on at the time.

2. **The Laventhol report and Firestone Group financial statements contradicted the unaudited financial statements in the Note and the Stock Purchase Agreement; the Laventhol report, therefore, could not have encouraged Herzfeld to retain the investment.**

The absurdity of concluding that Herzfeld "relied" on the Laventhol report is emphasized by contemplating whether he would have been encouraged to retain the units had he taken the trouble to read it.

To appraise Herzfeld's likely reaction, it is necessary to understand the purpose of the Laventhol report in the context of the private placement. In the Note and Stock Purchase Agreement, Firestone Group represented that the consolidated projected financial statements "will be correct and complete and will fairly present the financial condition of the Company . . . as at November 30, 1969" (9e), and it was a condition of closing that the representation thus expressed "shall be true on and as of the Closing Date" (8e). The method of implementing these agreements was described in Firestone Group's November 21, 1969 letter to Herzfeld accompanying the Note and Stock Purchase Agreement. Promising the future delivery of audited financial statements, Firestone Group wrote, "The audited statements will serve as the basis for confirming the unaudited Projected Financial Statements annexed to

the Note and Stock Purchase Agreement as Exhibit B" (5e). Thus, the purpose of giving Herzfeld the audited financial statements was to enable him to discover from them whether the unaudited projected financial statements, on the basis of which he originally invested in the units, were "confirmed".

The evidence is overwhelming that, if Herzfeld had read the audited financial statements he would have discovered that the projected financial statements were emphatically not confirmed. A multiplicity of uncontradicted facts points in this direction.

First, Herzfeld would have found that Laventhol was not willing to say that the audited financial statements fairly showed the Firestone Group's financial condition without excepting from its opinion the matter of the collectibility of the receivable described in the footnote. Second, had Herzfeld compared the audited financial statements with the unaudited financial statements, he would have seen that the figure for net income after taxes of \$315,000 contained in the unaudited financial statements (23e) had been reduced to \$66,000 (34e) in the audited statements. Third, had Herzfeld taken the trouble to pay any attention to the audited financial statements, he would have seen that the earnings per share was set forth on the face of the audited statements as only 10¢ per share. Fourth, had Herzfeld paid attention to the income statement at which he glanced, he would have seen that the \$1,795,500 "Deferred gross profit" was deducted from sales and referenced to "Note 4" (34e). Fifth, had Herzfeld read Note 4, he would have seen that Laventhol's qualification was, in effect, as to the future collectibility of the deferred gross profit (\$1,795,500) which so impressed him.

There is no doubt that Herzfeld would have made the foregoing observations had he taken the time to read the Laventhol report and the audited financial statements. We can conclude this from the fact that Herzfeld was a sophisticated investor* (256-259e) familiar with accountants' reports (323e) who had so heavily engaged in securities transactions that he and his brothers had formed an investment partnership which they had used as an investment vehicle for 20 years. However, we need not rest our conclusion on such circumstantial evidence. Herzfeld testified that the financial statements would have given him no encouragement had he read the qualification in the Laventhol report as the qualification would have meant to him that the financial statements were of no value (337e).

That Herzfeld would not have been encouraged by the Laventhol report and the Firestone Group audited financial statements is shown by the trial testimony of every witness who did read the Laventhol report and the audited financial statements. There is no dispute that Richard Firestone, president of Firestone Group, and Lee Meyer, an officer of Allen and a director of Firestone Group, regarded the Laventhol report and the audited financial statements as very negative (800-805a; 970-972a). Especially pointed testimony to this effect came from Robert Feinberg, the attorney who represented Firestone Group in the private placement. On direct, Feinberg testified about his concerns on first receiving the Laventhol report and reading it (971-972a):

"First, there was—it was clear that the operating results for the audited period did not conform with the projections that had previously been prepared by

* This was a private placement available only to such investors by reason of the exemption set forth in Section 4 of the Securities Act of 1933 (15 U.S.C. § 77d).

Firestone Group; and secondly, the balance sheet did not to the best of my recollection meet the net worth and other tests that had been set forth in the projections.

It was my judgment that there was a sufficient discrepancy between the projections and the financial statements that the company could not offer the securities on the basis of the offering circular without—or private placement memo, without further advice or notification to the subscribers.”

And on cross-examination, Feinberg reiterated the point (977-978a):

“Q. When you entered the conference room that day, [December 15, 1969] and studied the audited financials did you conclude that they did or that they did not confirm the financial picture which was reflected by the projected financial statements in the note and stock purchase agreement?

A. They did not confirm the projections.

Q. Were they, the audited financial statements, reflective of a more or less favorable financial position on the part of Firestone?

A. I think that's difficult to evaluate. I think I would say they did not conform, which gave us a problem, and I really don't think that the question can be answered in the manner in which it was phrased.

Q. Was the problem that they posed for you in going forward with the deal that they showed that Firestone was in a better financial situation then [sic] the projected statement?

A. They—the thing that I recall principally was that they showed substantially less earnings than what had been projected for the period.”

It was precisely this recognition by Firestone Group and Allen that the Laventhol report did not comply with their commitment to Herzfeld that led to the transmittal of cer-

tain "explanatory" material to him. Of that, more below. For the moment, it is important to note that everyone who did read the Laventhol report and audited financial statements regarded them as a substantially unfavorable departure from the favorable results shown in the unaudited statements. There is absolutely no reason to indulge the assumption that Herzfeld would have entertained a directly contrary view if he in fact had read them himself. Yet plainly, only such a showing would justify a conclusion that he was caused to retain the units by the Laventhol report, rather than by Firestone Group's own accompanying puffery.

3. Herzfeld's purchase and retention of the units were caused by his reliance on statements of Baird, Allen, Kramer and Firestone Group.

The record amply reveals what Herzfeld did rely on and what caused him to purchase and retain his units. As in *Titan Group, Inc. v. Faggen, supra* at 2670, "there was an abundance of evidence of the matters the plaintiff really considered important in entering this face to face transaction . . .". These were the advice and encouragement of his friends Baird and Kramer, the representations in the Note and Stock Purchase Agreement, and the representations in the December 16, 1969 letter wherein Firestone Group and Allen "explained" the substantial differences between the audited financial statements and the unaudited financial statements which had been supplied in the Note and Stock Purchase Agreement.

The Court's findings about the manner in which Herzfeld considered the facts he gleaned from Baird, Kramer and the Note and Stock Purchase Agreement fairly summarize the record (208-209a):

"Herzfeld first heard of the FGL private placement in November 1969 from his friend, David Baird, who

was a business broker. Baird told Herzfeld that Charles Allen regarded the deal as a good one and thought FGL was a very profitable company. In addition, Baird said, Allen thought that, with the 7.5 million dollars to be raised in the private placement, the company's future earnings should be even better. Herzfeld was enthusiastic about the securities after talking with Baird, especially since Charles Allen regarded the investment as a good one. Herzfeld was also encouraged by the prospect that the 5,000 shares of FGL stock in each unit would be split two for one and that FGL would buy back 5,000 shares of stock from each unit, at \$25.00 per share.

Herzfeld also discussed the FGL placement in mid-November 1969 with Irwin Kramer, Charles Allen's son-in-law and a partner in Allen. Kramer told him that Charles Allen thought the deal was 'the hottest deal he had ever seen' and offered to sell Herzfeld one unit.

Later in the month, Herzfeld received the FGL 'Note and Stock Purchase Agreement,' covering one unit of securities. He read the entire document, paying particular attention to the income statement. The income statement indicated to him that FGL was a 'very profitable company,' with earnings of approximately \$2.00 per share. Herzfeld calculated the value of FGL stock to be \$20.00 per share. The purchase agreement was accompanied by a letter from FGL advising that audited financial statements were being prepared. After reading the agreement, Herzfeld signed it, and he and his brothers also signed an agreement with David Baird, authorizing Baird, as their agent, to purchase one unit of FGL securities."

By the time Herzfeld received the Laventhol report and audited financial statements, he had already been sold the units by the efforts of Baird, Allen, Firestone Group and Kramer. Herzfeld was clearly swept along on a tide of

enthusiasm generated by Firestone Group and Allen, a tide he was still riding when he received the Laventhol report after the closing.

As already noted, at the same time Herzfeld received the Laventhol report, he also received a letter signed by Richard Firestone and dated December 16, 1969 (28-30e). This was the letter prepared by Firestone, with the apparent connivance of Allen, after Feinberg had been shocked by the adverse news in the Laventhol report. The letter papered over the differences between the audited financial statements attached to the Laventhol report and the unaudited statements which were attached to the Note and Stock Purchase Agreement (223a).

Laventhol had no part in preparing the Firestone Group letter, and it plainly misrepresented the purport of the Laventhol report and the audited financial statements. The Court below, noting that, "Obviously, the letter was intended to still investors' doubts about the private placement and convince them that the differences between the unaudited and audited financial statements were of no consequence", correctly went on to find that the statement in the letter "if not blatantly false, was plainly misleading", and that "Allen, through Meyer, knowingly misled investors by minimizing the material discrepancies between the audited and unaudited statements" (223a). Herzfeld accepted Firestone Group's false explanation of the differences between the financial statements audited by Laventhol and the unaudited financial statements without any recourse to the Laventhol report, and without any comparison of the audited statements to the unaudited projections (333a; 331-333e). On that basis Herzfeld decided not to return his units to Firestone Group.

* * *

In sum, it is plain that the Laventhol report did not cause Herzfeld to engage in either the purchase or the retention of the Firestone Group units. He did not and could not have relied upon that report for investment encouragement. The record demonstrates unequivocally his lack of reliance upon the Laventhol report and demonstrates convincingly that he relied instead on the zealous and misleading misrepresentations of others. Not only was the required "transaction causation" not affirmatively demonstrated by Herzfeld, but any presumption of causation which the Court below may have inappropriately indulged in this case was fully refuted by overwhelming evidence to the contrary.

The decision below was wrong as a matter of law and clearly erroneous as a matter of fact. It should be reversed with directions that the complaint be dismissed.

POINT II

The Laventhol report was not materially misleading.

The Court below concluded that the unread Laventhol report was materially misleading essentially on the grounds that: (a) the treatment of the transactions in the opinion, financial statements and footnotes, although not inconsistent with generally accepted accounting principles, did not adequately convey the "true financial position of Firestone . . . to the untutored eye of an ordinary investor" (192a);*

* For the purposes of the present point we abstain from continued reference to the fact that Herzfeld was by no means an "ordinary investor" and never cast his thoroughly tutored eye on the pertinent portions of the Laventhol report. Those facts, however, themselves warrant reversal and dismissal (Point I, *supra*) and may make it unnecessary for this Court to determine whether the vastly enlarged duty of disclosure imposed upon auditors by the Court below correctly states the law of this Circuit.

and (b) the report, financial statements and footnote did not include language describing certain of Laventhol's audit procedures and certain details about the Monterey transactions.

Laventhol submits that on each of these grounds, the Court below was wrong.

The Court did not purport to rest its interpretation of Laventhol's disclosure duty upon any attribution to Laventhol of deceptive intent. Quite the contrary, a fair reading of the Opinion suggests that the Court rejected the virulent contentions of Herzfeld and Allen in this regard.

There is, consequently, no question in this case of using generally accepted accounting principles as a veil to conceal the auditor's wilful participation in a fraudulent scheme. The reliance of the Court below (194a) on *United States v. Simon*, 425 F.2d 796, 806-07 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) is, therefore, inappropriate.

The determination of the Court below rests instead upon a novel doctrinal point: "[I]f application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately" (195a). The Court thus refused to distinguish between the duty of disclosure required of an auditor and the method of its communication on the one hand, and the larger and more discursive obligations of disclosure imposed by the securities laws on "insiders" on the other hand.

The net consequence of the Court's Opinion is to impose upon accountants entirely unforeseeable obligations of disclosure, apart from and beyond those demanded by generally accepted accounting principles. The particular dis-

closures thought to be necessary by the Court, if required at all, are the duty of an issuer in its prospectus or offering circular and have never been held to be required of auditors in the preparation and rendition of a certified audit report. The conclusion of the Court, if adopted by this Circuit, would represent entirely new law and would put the accounting profession at unacceptable hazard when it renders financial reports complying in good faith with the carefully established standards of the profession.*

Having adopted this new rule, the Court went on retrospectively to determine that additional matters—some of them patently inconsequential—were “*at least*” required in the Laventhol report (202a; Emphasis provided in Opinion). The disclosures apparently required by the Court’s listing were demonstrably inappropriate for an auditor’s report in any event; but the suggestion implicit in the emphatic indication that still further, unmentioned disclosures might have been required illustrates the opened risk to which the Court’s doctrinal innovation subjects the accounting profession.

We turn to a more detailed review of the error implicit in the Court’s determination of these two points.

A. The Monterey Transactions Were Real and Had to Be Reported; the Treatment Accorded Them Was Proper.

The gist of Herzfeld’s charge against Laventhol was that the audited financial statements delivered to Herzfeld on or about December 16, 1969 falsely reported the Monterey transactions as authentic when they were actually con-

* See Slain, *Fair Presentation*, 8 *Rev. of Securities Regulation* 983 (1975). For one view of the policy questions and practical problems raised by this novel requirement, see Liggio, *The Expectation Gap: The Accountant’s Legal Waterloo?*, 3 *J. of Contemporary Bus.* 27 (1974).

trived solely to sell the Firestone Group securities. According to Herzfeld, the audited financial statements should not have taken the Monterey transactions into account in any respect.

At the outset of the trial in the Court below, Herzfeld and Allen advanced colorful assertions that the Monterey transactions were "phony" and that Laventhol acted as "servile" accountants in auditing the financial statements and in issuing its report, all to the end that the private placement would be consummated (266a-3 *et seq.*; 266a-23; 266a-25). As the trial progressed, however, and evidence of the substantiality of the Monterey transactions mounted, Allen and Herzfeld retreated and contended that the transactions involved options only (508a). By the end of the trial, the testimony clearly established that the Monterey transactions were in fact real, and the result of difficult, arms-length negotiations (557-566a; 772-777a; 780-785a). Accordingly, the Court on the basis of ample evidence, rejected both of the plaintiff's successive characterizations of the transactions, finding: (1) that the Monterey transactions were not "phony" (195a) and (2) that "plaintiffs . . . failed to show that the Monterey transactions were options or should have been reported by Laventhol as options" (198a).

The audited financial statements, therefore, had to take the Monterey transactions into account in some way. Chazen, Laventhol's national audit partner and an accountant of prominence and standing in his profession, testified that generally accepted accounting principles *required* that revenues be recorded in the income statement for a particular period if: (1) the assets resulting to the seller by cash, contract or receivables are nonrefundable and the contracts non-cancellable; (2) the cash amount of the trans-

action is evident; and (3) the seller has performed substantially all the services required of him by the contract (853-854a).^{*} Chazen stated that the Monterey transactions met all these criteria.

Laventhol properly considered the Monterey transactions as events which had substantial economic significance for all of the parties involved. The cash deposits were non-refundable. The amounts of the purchase and sale were determinable. The contracts were enforceable in accordance with their terms. Firestone Group had performed substantially all the steps required in the earnings process. These factors required that, under generally accepted accounting principles, the revenues to be realized from the transaction as well as the offsetting costs of the sale, be recognized in the income statement for the period ended November 30, 1969 (852-853a). The inclusion of these transactions as economic events generating gross revenues and expenses was not only proper but required to avoid distortion of the income statement.

Laventhol then had to decide how much of the profit to be realized by Firestone Group on the Monterey transactions should be taken into current income for the period. Laventhol took a cautious approach to the current recognition of this income—an approach concededly more conservative than that of Firestone Group in its unaudited statement, and markedly less favorable than anticipated by Firestone or Allen (844a; 855a *et seq.*).

^{*} Indeed, plaintiff's own expert did not dispute these criteria for recognition of a transaction. He admitted on cross-examination that the contracts evidencing the Monterey transactions (144-154e) created events which had to be disclosed in the Firestone Group financial statements (411a), and that in these circumstances, current income on the statements could properly have included amounts reasonably likely to be received by Firestone Group within the period of the income statement or immediately afterwards (476-477a).

B. The Trial Court Erred in Failing to Consider Generally Accepted Accounting Principles and to Apply the Decisions of This Court to Determine Whether the Laventhol Report and Firestone Group Audited Financial Statements Made the Required "Material" Disclosures.

At the time Laventhol issued its opinion on the Firestone Group audited financial statements, the rules of the American Institute of Certified Public Accountants respecting an accountant's expression of opinion were contained in "Statements On Auditing Procedure No. 33" ("SAP 33"). SAP 33 described the circumstances in which an accountant's opinion that financial statements fairly presented the company's financial condition should be qualified, and the language to be used to express various qualifications. SAP 33 provides in part as follows (p. 58):

"When a qualified opinion is intended by the independent auditor, the opinion paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and should give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable. Reference in the opinion paragraph to a note to the financial statements or to a preceding paragraph in the report that describes the circumstances is an acceptable method of clarifying the nature of a qualification."

According to SAP 33, such a qualification is required if the accountant finds "unusual uncertainties as to the effect of future developments on certain items". SAP 33, Chapter 10 at 58, 72. SAP 33 amplifies the reason for qualifying an opinion on financial statements involving such

unusual uncertainties and describes the form which the qualification should take as follows (p. 72):

"The management of a company ordinarily is expected to evaluate matters affecting financial position and results of operations. In cases where the probable effects of a matter are not reasonably determinable at the time of the opinion, such as in the case of certain lawsuits, tax matters, and other contingencies which may have a material effect upon the financial statements, and the final outcome is dependent upon the decision of parties other than management, the independent auditor should appropriately qualify his opinion. In such instances use of the phrase 'subject to' is appropriate."

It is therefore critical to Laventhol's compliance with its duty of disclosure to note that an auditor's qualified opinion is the expression of his doubt produced by the existence of unusual uncertainties in the financial statements, in the mode authoritatively required by his profession.*

Laventhol expressed its view of the "unusual uncertainties as to the effect of future developments" on the Monterey transactions by doing precisely what SAP 33 commands. It qualified its opinion by stating that the audited financial statements fairly described the financial position of the company "subject to the collectibility of the balance receivable on the contract of sale (see Note 4 of Notes to Financial Statements)" (32e). The balance sheet and the income statement referred to Note 4 in five further, separate places.

* This significance of a qualified opinion is, of course, fully appreciated in the commercial world. See, e.g., *Hershman, Companies vs. Auditors*, 104 *Dun's Rev.* 33, 35 (1974). The point made here is equally critical to appreciating the extraordinary solecism involved in characterizing the qualification as evidence of knowing suppression of doubt. See Point III, *infra*.

Note 4 revealed facts supporting Laventhol's previously described reservations concerning "the collectibility of the balance receivable on the contract of sale" (32e). It stated that only \$25,000 had been paid on the signing of the contract of sale and that \$25,000 more was not due until January 2, 1970. It also set forth that the largest amounts to be paid under the contract had not yet been paid: \$4,965,250 was not due until January 30, 1970, and \$1,015,250 was to be paid to Firestone Group over a 25-year period. Finally, Note 4 set forth that the contract of sale contained a liquidated damage provision for \$185,000 which became operative "if the buyer fail[ed] to perform".

Indeed, the Court below found that Note 4 to the audited financial statements set forth "the financial terms of the Monterey-FGL and FGL-Continental contracts, including the liquidated damage clause in the latter, and recite[d] the treatment of the profit from the transactions" (199-200a). It also found that the qualification in Laventhol's report threw "some doubt on whether the transaction would be culminated" (201a).

In short, Laventhol had expressed its doubt by an appropriately framed qualification, and described the circumstances of its uncertainty by a fully referenced footnote, all in accordance with SAP 33. Nevertheless, the Court ruled, "more was required of Laventhol as an independent auditor" (201-202a).

What more? A review of the Opinion produces some startling further requirements. Disdaining generally accepted accounting principles as a sufficient mode of disclosure, the Court opined (192a):

"Much has been said by the parties about generally accepted accounting principles and the proper way for

an accountant to report real estate transactions. We think this misses the point. Our inquiry is properly focused not on whether Laventhol's report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of Firestone [Group], as of November 30, 1969, to the untutored eye of an ordinary investor."

Instead of determining whether the Laventhol report and the audited financial statements complied with "accounting norms" and disclosed all material financial information, the Court below said that the audited financial statements had to tell "all the material facts about the transactions . . . [because] the investors were depending on Laventhol to tell them what was happening at [Firestone Group]" (202a).*

This standard for determining the disclosure obligation of accountants certifying financial statements is, we submit, erroneous as a matter of law and insupportable as a matter of policy. Its effect is to leave accountants with no recognized medium of expressing financial conditions and events. It imposes upon them interpretive burdens previously thought to be the province of the prospectus writer. All this is imposed in the name of procuring a "true" statement of "what was happening" at the issuer. Such reportage vastly exceeds the scope and competence of any auditors, whose duty has always been to report fairly the financial condition of a company in terms that are uniform and consistent enough to serve as modes of comparison from company to company and from period to period. Of course such a medium of expression does demand some com-

* Herzfeld of course was not depending on Laventhol to such a degree that he felt it desirable to read what they did in fact report (see especially 336e).

petence on the part of the reader, a competence which, not incidentally, Herzfeld possessed. But that is no reason to abandon this conventional, uniform method of expression in favor of a wholly subjective and interpretive standard of disclosure which both puts the auditor at perpetual risk that someone else's interpretation will be later thought better and his therefore "misleading", and simultaneously destroys the uniformity necessary for the comparisons which are at the heart of financial analysis.

Technically, the issue of disclosure presented by the Court's Opinion turns on whether the "omitted" matters described by the Court below are material in the auditor's report. In determining the materiality of an incomplete or erroneous statement, "all the surrounding circumstances" must be taken into account. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.), 1973 *cert. denied*, 414 U.S. 910 (1973). This rule has been long-established in this and other circuits. *List v. Fashion Park, Inc.*, *supra*; *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). See also Kripke, *Rule 10b-5 Liability and "Material" "Facts"*, 46 N.Y.U. L. Rev. 1061 (1971).

It seems clear that all that is material in financial statements are facts sufficient for the fair presentation of the company's financial condition. The further duty to inform the prospective investor of non-financial facts to explicate the risks of investment—to tell him "what was happening"—is the obligation of the author of the offering instrument.*

* Even in this respect, the courts have been unwilling to assume the role of "copy editor, rearranging and shifting emphasis to meet its . . . ideal of objective reporting." *Browning Debenture Holders' Comm. v. DASA Corp.*, 357 F. Supp. 1010, 1012 (S.D.N.Y. 1972).

The Court's assumption that the duties of auditors and insiders are coterminous—aside from requiring horrific redundancy in future prospectuses—disconnects the accountant's disclosure obligation from the accounting expertise that gives rise to the obligation in the first place. The suggested enlargement of accountants' duties is not rooted in any legitimate investor expectations, or in the professional competencies of the accounting profession, or in precedent. It can only produce a confusion of roles inimical to the supposed objective of an informed marketplace. The best guide for determining the sufficiency of disclosure in an accountant's report and audited financial statements—absent a showing of deceptive intent by the accountant—is the pertinent rules prescribed by the accounting profession.

The determination of whether a particular disclosure in financial statements is material must also take into account the nature of the investors to whom the financial statements will be sent:

“The concept of materiality focuses on the weightiness of the misstated or omitted fact in a reasonable investor's decision to buy or sell.” *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, *supra* at 362.

Thus, the fact that Laventhol's report and the audited financials were to be sent to sophisticated participants in a private placement is also relevant in deciding the “materiality” of any alleged misstatements. *List v. Fashion Park, Inc.*, *supra* at 464; *Myzel v. Fields*, *supra* at 736; *Kohler v. Kohler Co.*, *supra* at 641-42. Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 *Harv. L. Rev.* 584, 602-06 (1975); Comment, *Reliance Under Rule 10b-5: Is the “Reasonable Investor” Reasonable?*, 72 *Colum. L. Rev.* 562 (1972).

The Court below was too simplistic in its approach to the standards of disclosure. It was also inopportune in choosing this case—involving a highly sophisticated but inattentive investor in a private placement—as the vehicle to impose upon accountants novel duties to satisfy the “untutored eye of the ordinary investor.” The Court was wrong, furthermore, in its application of the disclosure standards to the Laventhol report before it.

C. *The District Court's Conclusion That There Were Material Misstatements and Omissions Was Erroneous.*

The Opinion of the Court below determined that there were four affirmative material misstatements and ten material omissions in the Laventhol report. These conclusions were demonstrably erroneous.

1. *It was error to find the income statement misleading.*

Judge MacMahon's criticism concerning the income statement itself, apart from the opinion and footnote 4, is that Laventhol “included the profit from the [Monterey] transaction in the income statement” (203a). That simply is not the fact, as the income statement shows on its face. The “Deferred gross profit (Note 4)” of “\$1,795,500” listed on the income statement (34e) was plainly *deducted* from the line marked “Gross profit on sales (before deferred gross profit)”. It was, therefore, *excluded* from “Gross profit on sales,” from “Total income,” from “Income before income taxes,” from “Net income,” from “Retained earnings, ending,” and from “Earnings per share.” No reasonable man could have regarded the entire Monterey profit as “included” in the income statement—even on its face. And it is, of course, the *reasonable* investor to whose decisional process the law looks in this regard. *E.g., Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970).

Moreover, none of the sophisticated investors in this private placement of \$255,000-units would have regarded it as "included", especially without looking at either the note (to which they were directed by the deferred gross profit line itself as well as by the legend at the bottom of the income statement page) or the accountant's opinion itself. Quite apart from the fallacy of scrutinizing the income statement out of context, the income statement simply does not contain the material misstatement specified by the District Court.

2. The conclusion that there were three affirmatively misleading material statements in Note 4 was error.

The District Court held that there were three misleading statements in footnote 4 (which Herzfeld never read). The record does not support any such conclusion. The statements were obviously misread by the Court, and moreover, even if they were defective, the defects were not material.

(a) The Court's Opinion criticizes the note for conveying the impression that title to the properties had passed from Monterey to Firestone Group (200a). In fact, the note did not even use the word "title". Note 4 said that Firestone Group "acquired by contract of sale . . .". That was true.

The Court's feeling that use of the words "acquired by contract of sale" was equivalent to saying "acquired title" and was consequently misleading, rests on several misconceptions: First, it is based on the spurious notion that to record a transaction in the financial statements as an acquisition, legal title must have passed. This simply is not so: long term leases with options to purchase at the end of their terms and conditional sales with title reserved in the seller for security purposes are examples of transac-

tions in which legal title has not passed but an acquisition, in the current period, is properly reflected. Again, the Court's criticism of the precise choice of word and tense in "acquired" overlooks entirely the doctrine of equitable conversion by which equitable title may well have passed in these circumstances. Finally, the Court ignored the fact that buying and selling the contracts was the conventional means of conveying such properties in the assembly stage of real estate syndications (764a; 766a; 771-772a), a custom that the parties and auditors fully understood had been complied with here (550-552a; 778-788a; 852-853a). Therefore, to say that Firestone Group had "acquired by contract of sale" accurately portrayed the practical economic, equitable and business effects of the transactions.

Moreover, even if the language "acquired by contract of sale" standing alone were deemed misleading, for sounding too unequivocally in the perfect tense, the defect could not be material. Preceded as it was by the Laventhol report's qualification on the collectibility of the purchase price and followed as it was by the list in the balance of Note 4 of the payments made and *to be made* under both contracts, it could not have led anyone who read it—as Herzfeld of course did not—to believe that every aspect of the transaction had been concluded.

(b) The District Court found that Note 4 was misleading when it said that the deferred gross profit of \$1,795,500 "will be considered realized when the January 30, 1970 payment is received" because this language suggested the deal was certain to be completed (200-201a). On the contrary, the quoted language carried the plain implication that the conclusion of the deal was *not* certain when taken in the context of the Note itself (*e.g.*, the further language about

liquidated damages in event of default). Moreover, it is important to remember what the Court below forgot: the footnote is the explanation of the "unusual uncertainties" that compelled a qualified opinion; it cannot be read apart from the high level of contingency instinct in the text of the opinion to which, after all, it is a footnote. The quoted language amounts to saying, "We will count the \$1,795,500 as profit when we see it." To invest such an expression of contingency with intimations of certitude strains the language and distorts its context.

(c) The Opinion below states that it was misleading for Note 4 to say that "the properties were leased back to their former owners" because "Laventhol had no proof that the leasing back ever occurred" (201a). There is absolutely no evidence to support this finding. The trial record is devoid of any testimony that Laventhol did not see the lease. Neither counsel for Herzfeld and Allen who inspected Laventhol's files nor the Court ever asked the Laventhol witnesses whether Laventhol saw the lease.

The Monterey-Firestone Group contract recited the existence of the lease as Exhibit D thereto (376e), though the lease was not attached to the copy of the contract marked in evidence. However, the testimony of all witnesses having knowledge of the facts was that Laventhol received a complete copy of the Monterey-Firestone Group contract and all other relevant documentation (550-551a; 554-558a; 802a). There was no testimony whatsoever that the lease was not entered into and no testimony that Laventhol did not receive the lease which was Exhibit D to the Monterey-Firestone Group contract. The parties attacking the footnote never proved this phrase was anything other than entirely accurate.

In any event, even if the statement were not true, the only respect in which it could be deemed "material" is that it would convey hope that the Monterey transactions would be culminated and the profit realized. However, any such hope as might have been conveyed was certainly dispelled by the expressed reservations about the collectibility of "the balance receivable under the contract of sale" and the statement that the profit would not be considered realized until the January 30, 1970 payment was collected and that the contract of sale provided liquidated damages of only \$185,000 in the event of non-performance. Thus, any such encouragement that an investor who read the footnote might have derived from the statement that the properties had been "leased back" ought not be deemed material.

The "materially misleading" statements culled by the Court from footnote 4 were neither misleading nor material. It was plain error for the Court to hold that they were and that they would have misled Herzfeld if in fact he had deigned to look at them.

3. The Court erred in finding materially misleading the omission of ten items from the unread footnote.

The Court found the Laventhol report and the audited financial statements were further misleading because they "omitted" the following "facts" (202-203a):

"(1) Continental's net worth; (2) the ambiguity of the language in the contracts which might have suggested to some that they were options; (3) Ruderian, on whose reputation and representations Laventhol was depending, was not personally liable on the contracts; (4) Ruderian's practice of reselling property before he paid for it; (5) neither of the transactions was recorded in FGL's books of original entry or corporate minute books; (6) this transaction was the largest in

which FGL had ever participated; (7) FGL would show a loss if the income from the Monterey transactions were not realized; (8) FGL had not acquired title to the nursing home properties from Monterey; (9) no deed, title search or title insurance on the properties had ever been obtained by FGL; and (10) the legal opinion sought by Laventhol, on which it relied in treating the transaction as an enforceable purchase and sale, had been obtained over the telephone from an attorney who not only never saw the contract but never even had it read to him on the telephone." (Footnote omitted.)

This catalogue of supposed "facts" highlights the problem of applying the erroneous standards adopted by the Court for the disclosure duty of accountants. It is a *mélange* of descriptions of portions of audit steps, inaccurate assertions and inappropriate judgments. The conclusion that these "facts" were material and their inclusion required by Rule 10b-5 is plainly erroneous as a review of the catalogue demonstrates.

As a first example, the listing is altogether unbalanced, and hence itself misleading. The expression of negative facts listed by the Court as items 1 through 4, for instance, was no more necessary than the expression of positive facts, such as, that Continental was an operating company which could, in all probability, pay the \$185,000 liquidated damages (142-143e); that none of the principals regarded the contracts as mere options (198a; 771-776a; 824-829a); that Ruderian said he had never reneged on a deal and that he had the financial resources and the intention to complete this one; and that Laventhol knew that he did have an outstanding reputation and the financial resources to make good his promise. The "facts" in item 7 could not have been fairly stated without also saying "no

loss will occur if the \$185,000 liquidated damages is collected".

In other words, forcing the auditors to embark on a process of selective emphasis in an interpretative essay contained in their report requires a balancing act which they are not professionally competent to perform and which puts them at peril of a fall into civil liability if their judgment is later construed to have been faulty.

Or, as a further example, items numbered 2, 3, 5, 8, 9 and 10 are not so much ultimate financial facts as they are pieces of evidence accumulated and weighed by auditors for the purpose of deciding the ultimate financial fact that the Monterey transactions were real economic events. The auditors had an obligation to decide that issue and, having decided it, to display that ultimate fact in accordance with the standards for expression of financial facts. While it was proper for Laventhol to investigate and elicit such facts, as well as many others supporting their audit judgment, the inclusion of any or all of such evidentiary items in a footnote would have merely diluted the accountant's responsibility to be right in the accounting treatment given the ultimate fact about the Monterey transactions. As to that ultimate fact, the Court did not find that the transactions were a sham; it expressly rejected such a finding and concluded that Laventhol's judgment to treat the Monterey transactions as real economic events was justifiable. Having reached that conclusion, the Court was wrong in insisting that the auditors thereupon temporize about that judgment by the inclusion of such "data" as it suggests.

The character of this fallacy is perhaps best illustrated by the second of the supposedly omitted "facts": "the am-

biguity of the language in the contracts which might have suggested to some that they were options". This conclusion of the Court is truly inexplicable. The language of the contracts did not suggest to any of the parties that they were options; it did not suggest to the independent attorney whose view was sought by Laventhol that they were options; it did not suggest to the auditors that they were options; and the Court itself held that "plaintiffs have failed to show that the Monterey transactions were options or should have been reported by Laventhol as options" (198a). How then can the Court say that Laventhol, having made this judgment with which the Court agrees, should then have impeached that judgment as a "fact" in footnote 4?

Or again, the "facts" mentioned in items numbered 1, 3 and 7 were a few among many matters developed in the audit which Laventhol considered in deciding to qualify its opinion. It hardly lies in the mouth of Herzfeld, who did not read the qualification, to complain that some details underlying the accountants' conclusion that a qualification was required were not spelled out with the clarity he retrospectively would have liked. And it was wrong for the Court to fashion a theory of liability to a fictitious plaintiff, not before it, on the assumption that those facts would have likely influenced his hypothetical investment decision.

Other "facts" in the list are not facts at all or, at best, only half true. Thus, the Court again overemphasizes in item 8 that Firestone Group "had not acquired title to the nursing home properties from Monterey" a "fact" which is in truth a conclusion and which, on the record, is at odds with the realities of the transactions as recognized by corporate economics, equity and trade practice. The sugges-

tion in item 10 that the auditors had a duty to impugn the value of their independent check with an attorney as to the legal characteristics of the contracts is not only gratuitous and wholly immaterial to the disclosures demanded of auditors, but the "fact" is at variance with the record (847-851a; 924-930a). The purpose of the telephone call to counsel was not to solicit a "legal opinion" but to verify the judgments of Laventhol audit partners who themselves were qualified by training and experience to form a conclusion concerning the effectiveness of the contracts. Item 10 further illustrates the futility of the disclosure supposedly required by the Court. If these observations had been included in the footnote, would it not have been equally necessary to include explicitly in the footnote that the attorney's view was that the contracts were legal, valid and enforceable in accordance with their terms? And if the totality of the episode had been reported in scrupulous detail, would it really have informed Herzfeld in any significant way about the financial condition of Firestone, assuming that he had cared enough to read it?

Thus the "facts" catalogued by the Court and said to have constituted material matters omitted from the footnote cannot fairly be so construed at all. That is error enough, but it is not the most important error of the Opinion below on this point. The vice of this passage in the Opinion, which purports to be a minimal and non-exclusive list of such "facts", is that it sweeps away any plausible standard to which accountants could adhere in order to render a report which adequately discloses material facts. By holding (a) that conformity with generally accepted accounting principles is not enough and (b) by suggesting that such trivial, subjective, selective and unilluminating "facts" as the Court listed might be construed to be "material" for the purposes of meeting the larger standard of disclosure thus

imposed upon the auditors, the Opinion effectively removes predictability from the law governing the preparation of accountants' reports. This is a disservice to accountants, and, ultimately, to the investing public which relies on the application by accountants of some professional discernment in the data they furnish in their reports.

POINT III

The Court's conclusion that *scienter* had been proved on Laventhol's part was error.

The trial court held "that Laventhol had actual knowledge of the misleading nature of its report" (206a). This conclusion is without any support in the record and was reached by a process of circular reasoning that effectively eliminates *scienter* in the calculus of liability here, and poses a serious threat to the reporting function of auditors.

A. The Requirement of *Scienter* in This Circuit.

The requirement of *scienter* remains an essential element of a claim for damages under Section 10(b) of the Securities Exchange Act. A defendant's mere negligence is insufficient to permit recovery under Section 10(b) in the absence of recklessness so gross as to be functionally equivalent to wilful fraud. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, *supra*; *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1304-06 (2d Cir. 1973) (en banc); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, C.J., concurring), *cert. denied*, 404 U.S. 1005 (1971), *rehearing denied*, 404 U.S. 1064 (1972); *accord*, *Shemtob v. Shearson, Hammill & Co., Inc.*, 448 F.2d 442 (2d Cir. 1971); *Globus v. Law Research Service, Inc.*, 418

F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).
2 Bromberg, *Securities Law*, § 8.4 (585) at 204-13 (1974).

Reaffirming the principle that a defendant must have acted with culpability to be held liable under Section 10(b), this Court recently held, *en banc*:

"[O]ur recent decision in *Shemtob v. Shearson, Ham-mill & Co.*, *supra*, eliminated any doubt that proof of scienter is required in private actions in this circuit. There, in the context of a private action for damages, we stated that no violation of Rule 10b-5 occurs 'in the absence of allegation of facts amounting to *scien-ter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to de-fraud. It is insufficient to allege mere negligence.'" *Lanza v. Drexel & Co.*, *supra* at 1304-1305.

The record below is completely inconsistent with any such conclusion as to Laventhol.

B. Laventhol's Behavior As Disclosed by the Record Belies Any Scienter.

When all is said and done, it cannot be disputed that the Laventhol report and the financial statements indicated that certain steps in the Monterey transactions had not been culminated and that 90% of the anticipated profits could not be regarded as earned unless and until those steps were concluded. It further indicated that there were doubts about that outcome.

All of the Court's findings respecting concrete facts (as opposed to ultimate facts like "scienter") and all of the evidence in the record disprove the notion that Laventhol believed the Monterey transactions were unreal or that Laventhol believed its report and the audited financial statements were misleading in any respect.

The record clearly shows—and the Court found—that Laventhol made inquiries and conducted investigations to verify and confirm the Monterey transactions (182-188a). Lipkin, Laventhol's audit partner on the engagement, testified that he asked Morris Schwalb, the Laventhol accountant who was manager of the audit, and Firestone for documentation (915-918a). Martin Scott ("Scott"), vice president and director of Firestone Group, testified that he spoke with Laventhol personnel about the transactions and that he provided the documents (554-556a). Scott said that Laventhol asked him questions about the Monterey transactions and about who signed the agreements (557-558a). Scott testified that in response to Laventhol's questions he gave them "all the terms of the deal" (573a). Lipkin fully confirmed Scott's testimony as to his contact with Laventhol (934-939a) and the Court made no finding to the contrary.

Moreover, for auditors supposedly embarked on an intentional effort to defraud, a knowing use of a device to defraud, a wilful and deliberate coverup, a "reckless disregard for the truth", Laventhol partners took some quite extraordinary steps. One partner called Ruderian, whose excellent personal and business reputation he knew well, in order to obtain confirmation of Ruderian's intent to consummate the Firestone Group sale under the Ruderian agreement (820-821a; 824a; 826a). And the partner did obtain that confirmation (824-825a; 827a; 828-829a; 919-920a). Laventhol partners also consulted independent counsel to confirm the validity and enforceability of the agreements underlying the Monterey transactions, and the consultation did confirm that the agreements were valid contracts for the purchase and sale of interests in real estate (849-850a; 924-931a). The Court found in fact that both these steps had been taken (186-188a; 195-196a).

These steps are utterly inconsistent with any participation in a deliberate falsification or a wilful, reckless disregard of the truth. On the contrary, when Laventhol issued its report, it believed, and had ample reason to believe, that the Monterey transactions were real; its report and the audited financials so reported them in accordance with proper accounting practice.

When Firestone Group became aware of Laventhol's planned accounting treatment of the Monterey transactions, Firestone Group officers and directors objected strenuously. Firestone Group wanted all the profit from the transactions to be reported as income in the period ended November 30, 1969, and argued that unless all the income was so reported, Allen would be very upset (940-941a). Firestone testified that Meyer, a vice-president of Allen, agreed that all the profit should be included in income (803-805a). Meyer himself testified that he wanted to be sure that the profit was taken into the income statement because the transactions had occurred (715-716a), and the Opinion of the Court below found that all of this in fact had occurred (189a).

On December 15, 1969, Firestone Group and Allen met at the New York offices of the attorneys for Allen in the private placement and called Laventhol in California. Chazen and Lipkin were placed under great pressure to accept Meyer's and Firestone's contention that all of the profit from the Monterey transactions should be taken into income because the deal had been done (860-863a; 866-867a). The Opinion of the Court found that Laventhol resisted this pressure and refused to alter its report (189a; 224-227a).

In light of its finding that Laventhol was "justified" in treating the Monterey transactions as real events rather

than as "phony" or as options, and in view of Laventhol's independent audit investigations, its qualified opinion and its resistance to client pressure, the Court was plainly wrong in concluding that Laventhol's behavior satisfied the criteria for a finding of *scienter* under the cases in this Circuit.

C. *The Grounds for the Court's Finding of Scienter on Laventhol's Part Were Plainly Wrong.*

In the face of a record that conclusively showed that the auditors were prepared to wreck the private placement rather than relent in the conservative treatment their audit judgment indicated was proper, Judge MacMahon rested his determination of guilty knowledge on three arguments, all of which, we submit, were wrong. First, the Court found that Laventhol's audit had revealed to Laventhol all of his list of "omitted facts" (205a). Second, the qualification in the Laventhol report which the Court said threw "some doubt on whether the transaction would be culminated" (201a) indicated to the Court that Laventhol knew that its report and the audited financial statements were misleading because they failed to reveal "the uncertainties which Laventhol knew were lurking in the Monterey transactions" (205a). Third, "additional evidence of scienter" was found in two worksheets (prepared by an unidentified Laventhol staff member) which the Court plainly misconstrued (206a).

1. *Laventhol's knowledge of the "omitted facts" is not evidence of scienter.*

As appellant has already argued, the Court's list of supposedly "omitted facts" was composed of items that were neither facts, nor material, nor required to be set out in the Laventhol report (Point II, *supra* at pp. 45-49).

To be sure those items were not in the report, and Laventhol knew they were not. But to say, as the Court below did, "that Laventhol had actual knowledge of the omitted facts" is to beg the question central to the issue of *scienter*. That question is rather whether Laventhol did not include the "omitted facts" realizing all the while that they ought to have been included to make the statements not misleading. Laventhol's mere knowledge of the existence of such "facts" is a far cry from any realization that they ought to have been included, especially in view of the fact that accountants have never before been required to write narratives containing such facts.

There is no evidence which even suggests that Laventhol believed, or had reason to believe, that the report and the audited financial statements required any such material as the Court listed. That is, there is not a shred of evidence that Laventhol "omitted" anything which it felt ought to have been included. On the contrary, the overwhelming evidence is that Laventhol took great care to give proper treatment to the financial consequences of the Monterey transactions and to include in the report and the audited financials all facts material to that treatment, and, after doing so, resisted pressure from both Firestone Group and Allen to change the treatment of the transactions, to remove its qualification and to delete facts which were disclosed.

Thus, it was clearly erroneous to say that Laventhol's knowledge of the facts which the Court found "not included" showed that Laventhol excluded them with either fraudulent design or reckless disregard for the material fairness of the presentation in their report.

2. The qualification in the Laventhol report is not evidence of *scienter*.

The Court's finding that the Laventhol qualification was evidence of *scienter* is truly astonishing. Having concluded that the Laventhol report and the audited financial statements were misleading for not painting a gloomier picture of the Monterey transactions than warranted by the hindsight of the Court, one would expect a disposition to credit the accountants' qualification which concededly threw "some doubt" (201a) on prospects for culminating the Monterey transactions and realizing the anticipated profit (32e, 34e, 37e). Instead, the Court seized upon the qualification as evidence that Laventhol *suppressed* its doubts arising from the "great uncertainties . . . lurking in the Monterey transactions." Such reasoning should be rejected by this Court.

As appellant has already pointed out, a qualified opinion, such as that rendered here, that the financial statements fairly represent the operations of a company "subject to" a contingency thereafter described, is the precise and appropriate way under SAP 33 for an auditor to express his doubt about the outcome of the transaction to which the qualification refers. The pertinent standards permit this qualification in circumstances of "unusual uncertainty". Especially in the light of this standard, it was self-contradictory for the Court to hold *both* that the qualification cast some doubt on the outcome of the Monterey transactions *and* that it constituted evidence of the suppression of such doubts. The conclusion of the Court—which it expressed in the legal vernacular—that the Monterey transactions had not been shown to be "phony" and had not been proved to be options, but were of doubtful outcome, was the exact conclusion that Laventhol expressed—in the appropriate vernacular of accountancy—in its re-

port. To seize on such an expression of doubt as evidence of doubt suppressed is utterly unsupportable. To conclude from such an illogical exercise that the doubt expressed was *knowingly and culpably* suppressed stretches the train of illogic several steps further.

Surely the persons receiving the qualified report fully understood its negative impact. The Court is in the extraordinary position of (a) finding as a fact that Allen and Firestone Group were so shaken by the qualified opinion that they tried to coerce Laventhol to withdraw it, and at the same time (b) concluding that the qualification did not constitute a fair expression of doubt.*

If this Court does not revise the ruling that the qualification in the Laventhol report is a basis for finding *scienter*, that ruling holds the potential for enormous mischief in seriously inhibiting the use of such opinions as a proper device for accountants to inform the investing public accurately of their opinions.

3. The Laventhol audit work papers contain no evidence of *scienter*.

The trial court isolated two sheets from the Laventhol audit work papers which it found to contain evidence of *scienter*. These documents (155e and 420e) establish no such guilty knowledge.**

* Of course we can and do press the point further: since the qualification cannot be said, logically or practically, to be *any* evidence of *scienter*, it surely cannot be evidence sufficient to overcome the weighty showing of good faith during the audit and after the report was made (Point III, *supra* at 51-55), so as to prove this element of plaintiff's case by a fair preponderance of the evidence.

** It is fair to say, we believe, that if the Court had not fastened on the first two bases for finding *scienter*, it could not have found such *scienter* from the two workpapers alone in view of the total record of Laventhol's performance. If such a determination were to rest on these workpapers alone, it would be contrary to the overwhelming weight of the evidence.

The first document is a single sheet of notes (155e). Judge MacMahon in the Opinion stated that

“[t]his work paper shows Laventhol’s awareness of the vital importance of the Continental sale to FGL’s financial health, because the transaction meant the difference between FGL’s showing a profit or loss.” (206a)

Of course Laventhol was aware of this; everyone was. Indeed, the Laventhol report provides all the data necessary for an investor to draw the same conclusion for himself. The awareness reflected by the notes (155e) is simply no evidence whatsoever of a fraudulent or otherwise culpable state of mind.

The second workpaper (420e) labeled “Reclassification Journal Entries” was found by the Court to contain an entry showing that Laventhol believed that it was misleading to record the Monterey transactions. The Court misunderstood the workpaper.

As can readily be seen from the work sheet, its only purpose was to correct journal entries which had been classified improperly. The first two entries are not claimed to be otherwise. The third entry on the page, the one which the Court misunderstood, was an entry of \$1,066,000 currently payable income tax which was deleted so as to be entered as a \$1,066,000 deferred income tax item.

Although the unidentified handwriting under the third item said Laventhol “will not record (the Continental transaction) as sale”, that was obviously not intended to be taken literally by the unidentified person who prepared the paper, since to do so is wholly inconsistent with changing the \$1,066,000 current income tax liability to a deferred liability instead of wiping it off the books entirely. On the

other hand, this workpaper deferring the tax liability from the sale to Continental is entirely consistent with deducting the \$1,795,500 deferred gross profit from *current* sales as done on the income statement (34e) and with the "deferred" treatment given this item on all the other Laventhol audit workpapers (*See, e.g.*, 418e).

Thus, the conclusion is inescapable that the workpaper containing "Reclassification Journal Entries" (420e) is not evidence that Laventhol believed that the Monterey transactions should not be reflected on the Firestone Group balance sheet and income statement. The finding that it was evidence of *scienter* on Laventhol's part is clearly erroneous.

None of the three bases for the Court's finding of *scienter* withstands analysis, and its judgment should be reversed on that ground as well.

POINT IV

The Court erred in holding that plaintiff satisfied the elements of a cause of action for deceit or common law fraud.

The Court rests its finding that a common law fraud claim was established by the plaintiff upon what the Court concluded was proof of the five classic elements of common law fraud previously adopted by New York courts: representation, falsity, *scienter* amounting to an intent to deceive, deception and injury. *Kuelling v. Roderick Lean Mfg. Co.*, 183 N.Y. 78, 85, 75 N.E. 1098, 1100 (1905). The evidence in the record does not and cannot support any such findings here.

The showing required to establish a common law fraud claim is more onerous than that required under Rule 10b-5.

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963); *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969), *aff'd and modified on other grounds*, 478 F.2d 1281 (2d Cir. 1973); *Lerman v. Tenney*, 295 F. Supp. 780, 783 (S.D.N.Y. 1969), *modified on other grounds*, 425 F.2d 236 (2d Cir. 1970); *Pierce v. Richard Ellis & Co.*, 62 Misc.2d 771, 773, 310 N.Y.S.2d 266, 269 (Civ. Ct. 1970); 3A Bloomenthal, *Securities and Federal Corporate Law* § 9.21 at 9-74.2 *et seq.* (1974); 5 Jacobs, *The Impact of Rule 10b-5* § 11.01 at 1-164 to 1-167 (1st ed. 1974); Bromberg, *Are There Limits To Rule 10b-5?*, 29 *Bus. Lawyer* 167, 173 (1974). It is quite clear that conduct falling short of deliberate fraud or its equivalent will not be sufficient to hold an accountant liable for errors in his report and in audited financial statements. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931). All the arguments addressed in this brief to the District Court's erroneous conclusions as to (a) the existence of a material misstatement, (b) reliance by Herzfeld, and (c) *scienter* are *a fortiori* directed to the common law liability found below.

Beyond that, however, certain additional considerations should be mentioned. First, New York applies a presumption against finding fraud on the part of a defendant and in favor of the defendant's honesty, good faith and innocence. The burden of proving fraud rests squarely on the plaintiff who must rebut that presumption. *Kountze v. Kennedy*, 147 N.Y. 124, 41 N.E. 414 (1895); *First Nat. Bank v. Wright*, 207 A.D. 521, 202 N.Y.S. 774 (3d Dept. 1924), *aff'd*, 240 N.Y. 559, 148 N.E. 704 (1925); *Burstein v. Cohen*, 188 N.Y.S. 812 (1st Dept. 1921) (not officially reported). Such rebuttal necessitates evidence of fraud sufficiently convincing to tip the balance so that the weight of the evidence falls in favor

of fraud; if the evidence is equally consistent with dishonest intent and with innocence, fraud will not be inferred. *Spurr v. Hall*, 46 A.D. 454, 61 N.Y.S. 854 (4th Dept. 1899), *aff'd sub nom. Spurr v. Pisher*, 168 N.Y. 593, 60 N.E. 1120 (1901); *Aspell v. Campbell*, 64 A.D. 393, 72 N.Y.S. 76 (2d Dept. 1901); *Freedman v. Lloyd*, 22 Misc.2d 397, 199 N.Y.S.2d 709 (Sup. Ct. N.Y. Co. 1959), *aff'd*, 12 A.D.2d 591, 209 N.Y.S.2d 766 (1st Dept. 1960).

The standard of proof which Herzfeld would have had to meet to establish a common law fraud claim against Laventhol was applied in *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938). In *State Street Trust* the accounting firm was found to have issued a certified balance sheet which, at the time of issuance, it fully *knew* to be inaccurate. There were facts of which the accounting firm had actual knowledge and other facts of which it had the equivalent of actual knowledge (failure to make inquiry about or to take note of false and non-existent accounts as to which it had documentation) at the time the balance sheet was issued which showed that the balance sheet was materially inaccurate. The accounting firm was therefore condemned for its "active misrepresentation" and its total and reckless disregard for the truth of the balance sheet. This standard of proof was also applied in *Globus v. Law Research Service, Inc.*, 287 F.Supp. 188 (S.D.N.Y. 1968), *aff'd and rev'd on other grounds*, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), where a jury, on the same facts, found for the plaintiff on the federal claim but for the defendants on the common law cause of action.

As appellant has already argued, the facts concerning Laventhol's audit of Firestone Group vastly differ from the facts of *State Street Trust*. It is important to note that *State Street Trust* requires a plaintiff suing accountants at

common law to prove no less a degree of *scienter* than must be proved by a 10b-5 plaintiff under *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). The evidence contains no basis for finding any such culpable state of mind on the part of Laventhol (Point III, *supra*).

In short, it was error to hold Laventhol liable for common law fraud for all the reasons previously assigned, and for the further reason that the presumption of innocence recognized by the New York cases was not overcome by the requisite clear and convincing showing.

POINT V

No private cause of action arises under New York General Business Law Section 352-c.

The Court below held Laventhol liable civilly under § 352-c of the New York General Business Law. That statute makes it a misdemeanor to use or employ fraudulent representations in certain transactions in securities but sets forth no civil cause of action.*

* In pertinent part § 352-c reads as follows:

§ 352-c. Prohibited acts constituting misdemeanor

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices.

* * * * *

(c) *Any representation or statement which is false*, where the person who made such representation or statement: (i) *knew the truth*; or (ii) *with reasonable effort could have known the truth*; or (iii) *made no reasonable effort to ascertain the truth*; or (iv) *did not have knowledge concerning the representation or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities*, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted. (Emphasis provided.)

The Court below noted that "no reported New York case has gone to trial" (213-214a) on a purported civil cause of action under § 352-c and that "[t]he elements of a private cause of action under § 352-c are uncertain . . ." (213a). Nevertheless the District Court construed a civil cause of action to be inherent in the enforcement of the state criminal statute. It was clearly error for the Federal Court to adjudicate this unsettled question of New York law, the more so because the decision was gratuitous and the result wrong.

A. *The Court below should have Abstained from Reaching the Unsettled Question of State Law.*

The Supreme Court has recently reiterated its view that as to novel questions of state law, federal courts are ill advised to rush in where the state courts have feared to tread. See *Lehman Brothers v. Schein*, 416 U.S. 386, 391 (1974).

So here, the law of New York is plainly unsettled, and the highest court of New York has not even considered the question. Moreover, to the extent that the statute involved is criminal, it presumably embodies a significant statement of public policy of New York State upon which it is inappropriate for the federal courts to place a judicial gloss in the absence of real necessity. No such necessity appears here, since the Court below, having decided that a private cause of action existed under the New York statute, determined that its elements were precisely the same as those of a claim under Rule 10b-5. The judicial definition of New York law indulged in below was, therefore, an entirely alternative and fully redundant basis of decision and unwarranted under the circumstances.

It was error for the Court to reach and decide this issue.

B. The Court below Misconstrued the existing New York Authority under Section 352-c.

Having embarked upon an interpretation of the unsettled case law under § 352-c the Court below appears to have gone astray.

The case cited in the Opinion of the Court to justify its creating a civil cause of action on the basis of a New York criminal statute is *Barnes v. Peat, Marwick, Mitchell & Co.*, 69 Misc.2d 1068, 332 N.Y.S.2d 281 (Sup. Ct. N.Y. Co. 1972), modified, 42 A.D.2d 15, 344 N.Y.S.2d 645 (1st Dept. 1973). There, plaintiffs alleged a civil claim for violations of §§ 352-c and 339-a of the New York General Business Law and of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). Defendants moved to dismiss on the basis that no cause of action for damages was stated. The lower court denied the motion holding that it is the "better rule" to allow § 352-c to be used by private claimants.

However, on appeal, the Appellate Division modified the order authorizing maintenance of the suit by staying the action pending the disposition of identical claims in federal court. The Appellate Division made no explicit reference to the viability of civil claims under § 352-c but rather based its decision upon the specific ground that the "disposition of the issues" should be had in the federal court because of their "greater familiarity with the trial of those issues". *Barnes v. Peat, Marwick, Mitchell & Co.*, 42 A.D.2d 15, 16, 344 N.Y.S.2d 645, 647 (1st Dept. 1973). The practical effect of this modification was to leave in question the authority of Special Term's refusal to dismiss the private claim under § 352-c.

New York state courts have, on the contrary, declined to read a civil remedy into § 352-c on numerous occasions.* In *Stein v. Morey*, N.Y.L.J., Jan. 10, 1967, p. 17, col. 1 (Sup. Ct. N.Y. Co.), the court dismissed a cause of action based on § 352-c stating that:

"Nothing contained in that act would appear to give rise to a civil action by individuals claiming to have been injured by violations thereof. The act appears to provide for criminal proceedings as the only remedy for such violations [which] are commenced only by the Attorney-General of the State of New York."

Similarly, in *Kruger v. Zipperman*, N.Y.L.J., April 1, 1958, p. 7, col. 2 (City Ct. N.Y. Co.), the court dismissed a count of the complaint founded on § 352-c pronouncing that

"The plaintiff may not found any civil cause of action upon a violation of section 352-c of the General Business Law. That statute does not create a cause of action. It is a penal statute and reference to it has no proper place in this complaint."

C. The Trial Court Erred in its Application of Section 352-c.

The Court below also erred in determining the elements of any such § 352-c cause of action as may exist. The Court, though paying lip service to the time-honored rule that proof of *scienter* is essential, in effect held here that proof of *scienter* is not necessary to establish such a claim (214a).

* Indeed, *Herdegen v. Paine, Webber, Jackson & Curtis*, 31 Misc. 2d 104, 220 N.Y.S.2d 459 (Sup. Ct. N.Y. Co. 1961), cited by the Court below, means either that no civil action may be predicated on § 352-c at all or that a relationship of privity between plaintiff and defendant is required to make out such a claim. The latter, of course, no longer is a requirement under Rule 10b-5, and no such showing of privity was or could be made here.

The opinions of both Special Term and the Appellate Division in *Barnes* contain language making it plain that any such cause of action as may exist under § 352-c does not relieve a civil plaintiff from the obligation to prove all of the elements of what, in federal jurisprudence, is a Rule 10b-5 claim, including *scienter*. Special Term in *Barnes* stated that the civil cause of action under § 352-c was for "fraud or deception" and clearly used those words at least in the sense of a 10b-5 claim, and perhaps in the more rigorous sense employed at common law. The Appellate Division's view in *Barnes* that the federal courts have a "greater familiarity" with the issues raised by the pleading clearly implied the same conclusion.

* * *

Having inappropriately reached the § 352-c issue, the Court below should have held that no cause of action for damages exists under § 352-c and that, if there were such a cause of action, for the reasons expressed in Points I through IV above, Herzfeld's § 352-c cause of action should be dismissed for failure of proof.

CONCLUSION

The Amended Judgment of the District Court should be reversed and the cause remanded to the District Court with instructions to enter judgment dismissing the complaint, or, in the alternative, with instructions to vacate the Amended Judgment and to hold a new trial.

Respectfully submitted,

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